WRITTEN STATEMENT OF

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FEDERAL HOME LOAN BANK OF INDIANAPOLIS

TO THE MICHIGAN HOUSE BANKING AND FINANCIAL SERVICES COMMITTEE

OCTOBER 23, 2007

FHLBI

Introduction

The Federal Home Loan Bank of Indianapolis is one of 12 regional banks that make up the Federal Home Loan Bank System. Our primary mission is to support low-cost housing finance. The 12 FHLBanks are government-sponsored enterprises created by Congress to ensure access to low-cost funding for insured financial institutions, such as commercial banks, savings institutions, credit unions and insurance companies. The System is structured as a cooperative, owned and controlled by its 8,100 member institutions. The Indianapolis Bank was chartered to serve financial institutions based in Michigan and Indiana. In Michigan, there are 221 member financial institutions that borrow or sell home mortgages to our Bank.

The Federal Home Loan Banks not only support fair lending, but we also help carry it out every day in the communities we serve. Through mortgage purchase programs, we fund residential mortgage loans that must comply with our rigorous fair lending and anti-predatory lending guidelines. That is, our member financial institutions are not permitted to originate and sell residential mortgage loans to our Bank or any other Federal Home Loan Bank unless there are ironclad assurances that the loans comply with all fair lending and anti-predatory lending laws and regulations.

We also provide liquidity to our member financial institutions through lines of credit known as "advances," which are secured by residential mortgage loan assets held by our members. In fact, as a result of the recent subprime liquidity crisis, members have increased their usage of funds provided by the Federal Home Loan Banks. We have provided these additional funds so that they can continue to make home loans available to homeowners who may not have other ready mortgage loan sources during these difficult times.

Policy Challenge

Against the backdrop of the credit crunch and the subprime liquidity crisis, there remain homeowners and homebuyers in Michigan who desperately need credit on fair, reasonable and market-based terms. That is, there are citizens here in Michigan who still want to purchase homes, refinance their existing homes or obtain additional home-secured credit to satisfy family needs (such as college education). The challenge today to Michigan legislators appears to be two-fold: (1) responding to the marked increases in foreclosures and loss of homes, particularly the devastation caused to individuals who were provided "teaser rate" loans and "no documentation" loans and the like that were not appropriate for many consumers to begin with, and (2) preventing the current harmful situation in housing and home finance from repeating itself in the future.

But there is a third, and very significant, challenge before you: assuring that reasonable, fair and market-priced home loans will be available to Michigan homeowners and homebuyers in the future. This is an all-the-more important goal, as many residential mortgage lenders already have shut down or withdrawn from the market, and not just subprime lenders. The pullback, though much more pronounced for subprime lenders, has negatively affected the availability and cost of nearly every type and strata of home loan in Michigan. It is likely, as well, that homeowners facing default may need more than ever the ability to access a variety of credit options. In years past, for example, homeowners in distress due to payment shocks or an inappropriate mortgage product structure could access a variety of home loan options to restructure a troubled loan. In the current crisis, this refinancing option for consumers still remains vitally important.

We commend Michigan lawmakers for responding decisively to today's challenges to home ownership and for assuring that citizens are treated fairly. But we urge you to keep the importance of the availability of fair and desirable home mortgage credit front-and-center in these deliberations. It is possible for any well-meaning body of legislators to go too far, and actually harm the well-being of consumers that we all wish to protect.

Predatory lending laws have been enacted in approximately 40 states and localities, including Michigan's law, Consumer Mortgage Protection Act 660 of 2002 (Section 445.1631 et seq.). These laws are based on a part of the federal Truth-in-Lending Act known as the Home Ownership and Equity Protection Act or "HOEPA". These laws ordinarily are targeted at higher-cost home loans where the interest rate and closing fees are well above market norms. The more recent trend in state legislatures is to take a more comprehensive approach to mortgage lending regulation, as has occurred recently in such states as Indiana, Ohio, Maine, North Carolina, Minnesota and Nevada. It has been shown, however, that even the most well-meaning legislators and policymakers can go too far with these enactments. There can be unintended consequences and negative ramifications arising out of non-standard, novel statutory provisions.

Legal uncertainty can and does arise from the best intentions to protect consumers, resulting in enactments that are too uncertain and thus too risky for compliance-oriented, well-established mortgage lenders and secondary market participants to bear. Experience of compliance-oriented lenders and funders, such as the Federal Home Loan Banks, demonstrates that this may occur for three reasons: (1) ambiguous, non-standard or subjective provisions that cannot be incorporated into objective, reasonable lender compliance programs; (2) either unknown or unquantified liability imposed on assignees or secondary market participants; and

(3) strict and severe liability on loan originators for violation of laws that again could not be understood or complied with at the point of making a loan. And of course we know from experience that the consumer ultimately suffers if sensibly priced, otherwise lawful mortgage loans suddenly (if not unexpectedly) are no longer available. The mortgage market will likely fill the gap, but at a much higher interest rate to the consumer. For example, when the Indiana anti-predatory lending law, Ind. Code Sec. 24-9-1, was passed in July 2005, Standard & Poor's (S&P), the third-party independent credit rating agency, would not favorably rate the mortgages eligible for sale into the secondary market. Without the favorable rating, the Federal Home Loan Bank could not purchase these mortgages because of Indiana's inadvertent imposition of assignee liability. Finally, after the Indiana law was amended twice, S&P made a favorable determination on the credit ratings for the affected Indiana home mortgages. The secondary market exception to the Indiana law for regulated federal institutions was then recognized, and the market disruption which precluded the sale of Indiana loans to regulated federal institutions and the government-sponsored enterprises (GSEs) was corrected. To Michigan's credit, we have not had these market disruptions in your state.

Ironically, it is the most compliance-oriented community bank lenders that will have the most concerns over unquantifiable and unknown liabilities created by novel and untested approaches to mortgage lending regulation. The Truth-in-Lending Act, the Fair Credit Reporting Act, the Equal Credit Opportunity Act and the Real Estate Settlement Procedures Act, to name a few of the federal laws applicable, all impose strong legal duties on mortgage loan originators. Many provisions of existing Michigan law do so, as well. It appears these laws were not enough to prevent current difficulties in the housing market, particularly as they relate to the expansion of nontraditional mortgage products to a broad nonprime market. But the question remains for conforming lenders, such as those with whom the Federal Home Loan Bank of Indianapolis does business: if new, novel and unprecedented standards are put in place that apply to all mortgage loans, just what will compliance-oriented lenders have to do to satisfy the law? And how will consumers in Michigan be affected?

Why is the concern over the "secondary market" warranted? It is well known that two-thirds or more of all residential mortgage loans ultimately are sold and transferred to entities like Freddie Mac, Fannie Mae, the Federal Home Loan Banks and private or non-agency investors. The secondary market, including the activities of the Federal Home Loan Banks, provides an expansive source of lower cost mortgage funds to homebuyers and homeowners. In recent months, the workings of the secondary market have been in the headlines, as it appears that inappropriate loans were made to borrowers who did not understand basic loan terms and now cannot afford to pay them back. Many of these loans were arranged by mortgage brokers and funded by "wholesale" lenders with funds from companies that are outside the purview of the federal or state banking regulators. But the majority of the overall mortgage market, including the segment in which the community banks and Federal Home Loan Bank of Indianapolis are active, is not the cause of the mortgage liquidity crisis and the subprime problem. It is in everyone's best interests, particularly homeowners and homebuyers, for a sound and well-regulated secondary market to continue to function.

Secondary Market Explained

Just what do we mean by "secondary market?" The secondary market works as follows:

- Mortgage loan originators make loans that are sold (assigned) to investors, often in "pooled" transactions or "securitizations." The holders of these pools of mortgages, who include Fannie Mae, Freddie Mac and investment banks, in turn sell securities to investors such as pension funds, mutual funds and insurance companies. These investors purchase "securitized" notes or investment certificates from the secondary market participants, and this cash ultimately is provided to mortgage bankers who make it available to individual borrowers in the form of residential mortgage loans. The recent problems that have emerged have been largely concentrated in the non-conforming segment of the market known as private, non-bank or non-agency transactions (not conducted by Fannie Mae, Freddie Mac or the Federal Home Loan Banks). A few large national banks and thrifts have participated in the subprime market, but new federal regulations should address the origination and consumer disclosures for these national players.

- In the case of the Federal Home Loan Banks, member institutions sell mortgage loans to the FHLBanks and the FHLBanks in turn hold and through servicers collect the payments on the loans. In the alternative, member institutions may assign home mortgage loans to a Federal Home Loan Bank as collateral to secure funding in the form of advances. Institutions may use these advances to make more consumer mortgage loans. Thus, the Federal Home Loan Bank of Indianapolis and the other District FHLBanks provide funds to the member financial institutions, so that these institutions may make loans directly available to homeowners and homebuyers. Our low-cost funding, and our reliable, immediate access for our regulated member institutions (community banks, thrifts, credit unions and insurance companies) in all market conditions, means that homebuyers receive fair, competitively priced home mortgages.

- The providers of the funds in the secondary market, including the Federal Home Loan Banks, hold mortgage loans that have been assigned to them but that were originated by other lenders. The Federal Home Loan Bank of Indianapolis, in fact, entered into the secondary market in 2000. Today, we hold $9.5 billion of residential mortgage loans that were originated by our member financial institutions. Our program, called the Mortgage Purchase Program (MPP), was developed in response to our community bankers' requests to have a competitive funding alternative for the high-quality home mortgage loans that they issue. We acquire residential mortgage loans only after receiving assurances that all loans were made on fair terms and in compliance with all laws and the federal regulations. The Federal Home Loan Bank of Indianapolis simply does not under the federal guidelines purchase or provide funds for abusive, unfair or predatory home loans. We sample our loans to make sure this is the case.

Assignee Liability

The efficiency and certainty of these secondary market structures is critically important to homebuyers and homeowners in Michigan. In fact, Michigan homebuyers and homeowners rely on the flow of capital from these markets to obtain housing and the benefits of home ownership at competitive rates. It is common for state legislatures and other policymakers to desire to make the ultimate provider of mortgage loan funds liable for any bad acts that may have occurred when the loan was solicited and made. It is thought that these laws will police the marketplace and drive out bad actors. Laws that impose liability on remote holders of mortgage loans or purchasers of mortgage-backed investments are known as "assignee liability" laws. The federal Truth-in-Lending Act contains carefully crafted limitations on assignee liability. Some state "predatory lending" laws have not caused market disruptions or triggered the need for costly credit enhancements because by design these laws do not provide assignee liability (such as the North Carolina and California anti-predatory lending laws and the recent comprehensive Ohio Home Loan Protection Act) or provide clear standards for determining it (such as the Georgia law). As noted above, the Federal Home Loan Banks are not permitted to purchase or fund residential mortgage loans originated in states that impose unknown or unquantifiable liability upon loan purchasers. The Treasury Secretary has also recently expressed concerns about imposing assignee liability for this very reason.

Institutional loan purchasers such as the Federal Home Loan Bank of Indianapolis rely on minimizing uncertainty, both legal and economic, in providing residential mortgage loan funds. Economic uncertainty arises out of the ability of the borrower to repay under the terms of the debt, and this uncertainty is mitigated when the loan is originated under prudent credit underwriting standards. However, if legal risks, such as damages arising out of lawsuits, cannot be quantified, then secondary market participants will hesitate before putting capital at risk. Thus, given the subprime crisis we urge you not to use it as the reason to "experiment" with imposing liability on secondary market participants in all residential mortgage loan transactions, particularly as to residential home loans that we purchase from or fund with advances to our regulated member financial institutions. We encourage you to avoid negative consequences for Michigan borrowers that broad assignee liabilities create. Such consequences include higher loan rates or the unavailability of mortgage products. This is particularly important today given the pervasive lack of liquidity in the mortgage markets.

Flexible Underwriting

The hearings you are conducting now likely will point toward a comprehensive legislative approach to residential mortgage woes in Michigan. You will want strong legislation with powerful incentives on lenders and others to act fairly and lawfully. Non-bank mortgage originators (not affiliated with a regulated bank, credit union, thrift or insurance company, or their subsidiaries or affiliates) should be licensed and regulated by the state, and if necessary the anti-fraud laws strengthened. Michigan policymakers should verify whether adequate state resources exist to investigate home mortgage originations for improprieties, if the lender is not otherwise subject to federal regulatory oversight.

Care should be taken in thoughtfully tailoring legislation that is aimed to eliminate documented abuses in the mortgage lending market without unduly discouraging legitimate lending. It is possible to conclude, for example, that certain loan features such as "limited documentation" loans should be eliminated outright. But that would ignore the fact that these loans are appropriate, in the right circumstances, for particular borrowers such as new legal immigrants who do not have extensive credit histories or immediately verifiable W-2 income. The same can be said for other mortgage loan features that may be harmful to many borrowers, particularly in the subprime arena, but that are clearly beneficial to others. An example here is the accepted fair lending practice of lender flexibility regarding required debt-to-income ratios.

It may appear, as well, that broad and far-reaching prohibitions and limitations must be imposed on the mortgage market as a whole. However, policymakers here should avoid the temptation of confusing broadly-worded, subjective standards with effective consumer protections. First of all, subjective standards that require mortgage lenders to determine suitability, or to "reasonably verify income" or establish "reasonable tangible net benefit" in all loan transactions may well be too broad. That is, it would not seem appropriate to impose the same level of restrictions and prohibitions on conforming home loans, particularly first mortgage loans that ordinarily are fully underwritten and made to creditworthy borrowers that might be imposed on subprime or higher-cost home loans.

You may know that mortgage lenders before making a loan ordinarily conduct due diligence on the borrower's credit standing, the value of the collateral and the borrower's employment and income history. This process, known as "underwriting," has become very standardized and in large part automated today. The information needed to underwrite and close a mortgage loan for a consumer begins with a standard form loan application known as a "1003." The borrower provides basic identity and financial information about himself or herself, and the operative parts of the form 1003 are two pages long. Then the broker or lender orders credit reports and an appraisal of the home and obtains various verifications (including tax returns), which again are prepared or printed on "standard" forms. State and federal laws currently do not mandate how underwriting must be done for prime and conforming, except the federal regulators have recently provided some guidance for "nontraditional" and subprime mortgage loans.

Mortgage lenders offering conforming loans are permitted in underwriting to weigh various factors with flexibility tailored to individual borrower situations and needs. The performance of conforming or "prime" loans bears out the fact that this process works well for the majority of borrowers. Also subprime loans do provide needed credit to individuals that otherwise would not qualify. With this, it can be expected that foreclosures rates in this product sector will normally be higher. For example, in a recent study the Government Accountability Office (GAO) found that notwithstanding sharp increases in foreclosure rates, the subprime market experienced substantially steeper spikes in default and foreclosure start rates than the prime or government-insured markets; subprime loans accounted for two-thirds or more of the overall increase in the number of loans in default or foreclosure during the relevant time frame. Moreover, due to standardization and automation, the time between the consumer requesting a mortgage loan and the closing of the loan has been reduced from around 90 days to about 30 days in the last 10 years or so. Consumers have come to expect this level of service. In the end, consumers benefit from current mortgage loan underwriting practices, enjoying quicker access to loan funds at a lower cost of delivery. In this sense, the efficient operation of the mortgage market in this country, with record home ownership levels, is the envy of the world.

The Federal Home Loan Bank of Indianapolis requires that the loans we purchase or fund conform to prudent underwriting standards. We maintain and enforce extensive underwriting guidelines that our member institutions must follow in order to sell a loan to us. Our practices are consistent with other conforming secondary market participants such as Fannie Mae and Freddie Mac. For this segment of the market, there is no need to impose additional, restrictive loan underwriting "do's and don't's."

Conclusion

In summary, as you develop new consumer protections in Michigan, we urge you to carefully consider established legal precedent, experiences of other states with this type of legislation and, most importantly, consumer access to fair and affordable mortgage loans. By doing so, you will assure that Michigan families are not disadvantaged in pursuing their dream of homeownership. Thank you for your attention today. I will be happy to answer any questions from the Committee now or in the future as the Committee continues to develop legislation on this important matter.

Respectfully submitted,
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FEDERAL HOME LOAN BANK OF INDIANAPOLIS

Building Partnerships. Serving Communities.

Fostering Responsible Home Mortgage Lending

October 23, 2007

Briefing to Michigan House Banking and Financial Services Committee

Jonathan R. West
Senior Vice President and General Counsel

Agenda

Building Partnerships. Serving Communities.

- FHLBank System Introduction
- Mortgage Market Overview
- Mortgage Market Originations
- Foreclosure Trends:
  - National
  - Michigan
- Factors Causing Foreclosures
- Rating Agency and FHLBank Response
- Policy Considerations

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FHLBank Introduction

Building Partnerships. Serving Communities.

- 12 FHLBanks and 8,100 member – retail lenders (commercial banks, savings banks, credit unions and insurance companies) are the largest source of mortgage lending in the United States

	12 FHLBanks	FHLBI
Advances	$640 billion	$22 billion
Mortgage Purchases	$94 billion	$9 billion

- 80% of the nation's banks rely on FHLBanks for liquidity for housing and community economic development
- FHLBI serves Michigan and Indiana retail lenders

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FHLBI - Money Wholesaler

Building Partnerships. Serving Communities.

- Each FHLBank is privately-owned by our retail members
- Chartered by Congress – federally regulated
- No federal appropriations
- Raise low-cost money by selling CO bonds to institutional investors worldwide
- Fully-collateralized home mortgage lender or purchaser
- AAA-rated, never suffered a credit loss on an advance

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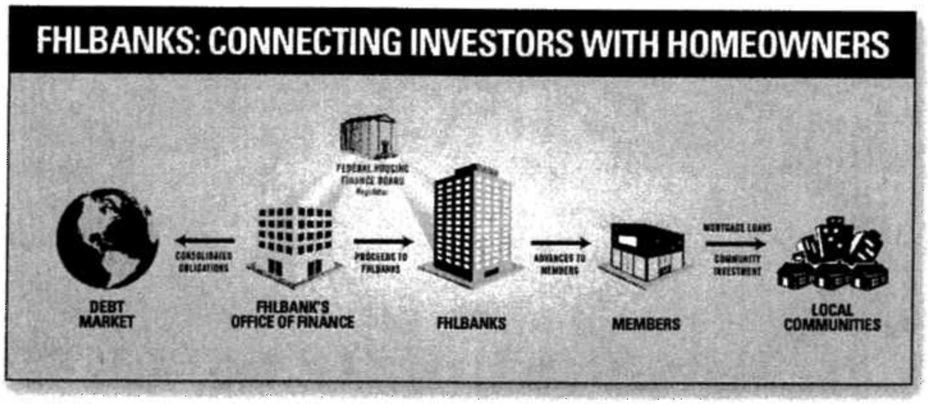
Building Partnerships. Serving Communities.



Largest Michigan Members

Building Partnerships. Serving Communities.

As of Dec. 31, 2006

		Assets (in billions)
Jackson National Life Insurance, Lansing		**$67**
LaSalle Bank Midwest NA, Troy (now B of A)		**50**
Fifth Third Bank, Michigan, Grand Rapids		**48**
Flagstar Bank, FSB, Troy		**15**
Citizens Bank, Flint		**13**
Auto Owners Insurance Co., Lansing		**9**
Blue Cross & Blue Shield of Michigan, Detroit		**5**
Chemical Bank, Midland		**4**
Auto Club Insurance Association, Dearborn		**3**
Macatawa Bank, Holland		**2**

Affordable Housing Program

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- 10% of annual FHLBI profits
- Granted to low-income families for down payment assistance or rent subsidies
- $47.9 million to Michigan families since 1990
- 8,555 units supported in Michigan

Saginaw Habitat for Humanity

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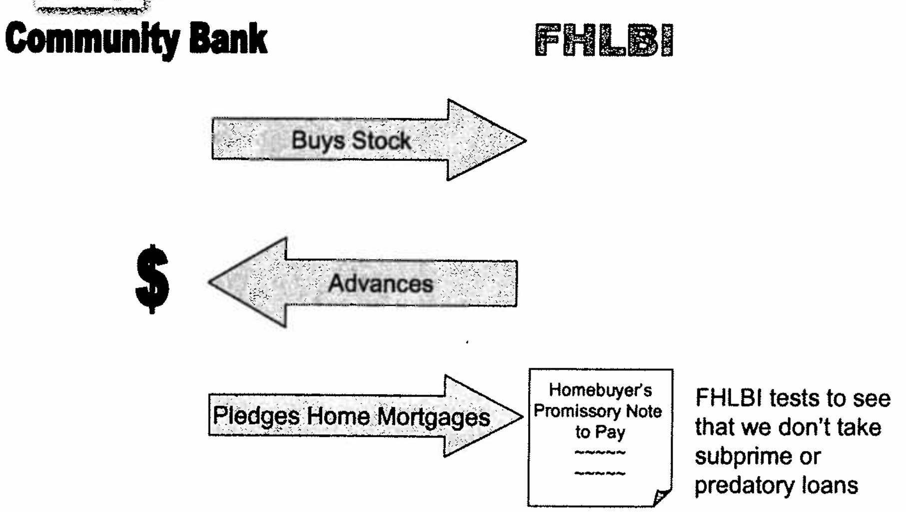
FHLBI's Role in Responsible Lending – Advances

Building Partnerships. Serving Communities.



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Role of Secondary Market

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- Major source of investor capital for new home loans – national commodity
- Allows FHLB members to get loans off books for capital and interest rate risk management purposes
- Lowers home mortgage costs for consumers

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FHLBanks Do Not Purchase Subprime or Predatory Loans

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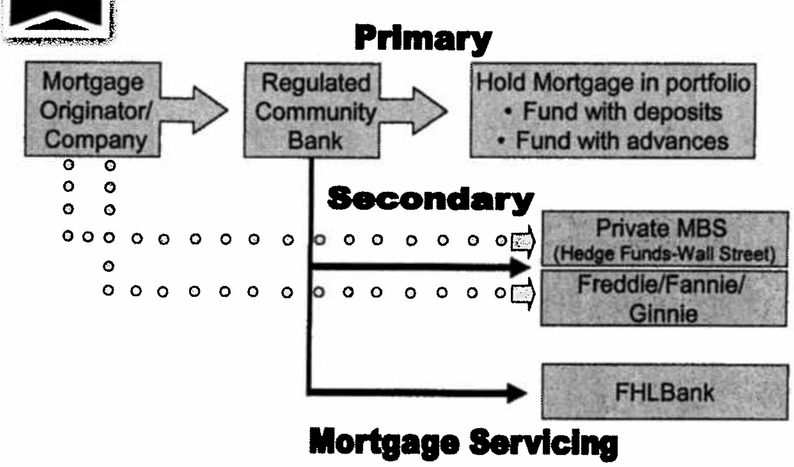

- Often sold to a large national third party – makes loan restructuring more difficult and foreclosures slow

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○ ○ ○ Created Subprime Mortgage Market

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- **Good:**
  - Provided opportunity for individuals not otherwise qualified for traditional financing
  - Initially lower down payment or monthly payments
- **Bad:**
  - Teaser rates below market, ARMs reprice to a payment that consumer cannot afford
  - Interest-only loans – forced refinancing
- **Ugly:**
  - Predatory loans – unregulated originators fraudulently preying on unsuspecting homebuyers and homeowners needing cash or money for repairs

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Mortgage Market Overview

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- **Defaults and foreclosures have risen sharply over the last two years but have varied significantly among market segments, loan types and states:**
  - Default and foreclosure rates grew to levels at or near historical highs
  - Subprime and adjustable-rate mortgages accounted for more of the overall increase

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Mortgage Market Overview

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•Economic/market developments contribute to foreclosure trends:

- **House price changes** reduced incentives for borrowers to keep current on their mortgages or made it more difficult to avoid foreclosure
- **Aggressive lending** practices reduced the likelihood that some borrowers would be able to meet their mortgage obligations
- **Growth in private mortgage-backed securities (MBS)** market provided liquidity to support lending practices

Source GAO October 10, 2007 Draft Study

Mortgage Market Overview

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•Primary mortgage market segments:

- **Prime** – serves borrowers with strong credit histories and provides the most competitive interest rates and mortgage terms
- **Alt-A** – serves borrowers with credit histories close to prime, but loans often have one or more higher-risk features such as limited documentation of income or assets. (Generally purchased by other GSEs.)
- **Subprime** – serves borrowers with blemished credit and features higher interest rates and fees. (Generally purchased by private MBS market, large banks, hedge funds, Wall Street.)
- **Government-insured or guaranteed** – serves borrowers who have difficulty qualifying for prime mortgages but features interest rates competitive with prime in return for payment of guarantee fees. FHA and VA: two federal programs that insure or guarantee mortgages

Mortgage Market Overview

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•Mortgage market offers a range of loan products:

- **Fixed-rate mortgage** – interest rate unchanged over life of loan
- **Adjustable rate mortgage (ARM)** – interest rate changes periodically over life of loan based on changes in specified index
- **Hybrid ARM** – interest rate is fixed and relatively low (teaser) during an initial period then "resets" to an adjustable rate. If rates rise, consumer payments may be higher than what they can afford. In the subprime market, 2/28 loans (fixed rate for two years, adjustable rate for 28 years) are common
- **Option ARM** – borrower has multiple payment options each month, which may include payments lower than needed to cover interest (deferred interest is added to the loan balance)
- **Interest-only mortgage** – borrower pays just the interest on the loan for a specified period, thereby deferring payment of principal

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Mortgage Market Overview

Building Partnerships. Serving Communities.

•Other mortgage market definitions and products:

- **Piggyback or home equity loan** – simultaneous second mortgage allows borrower to make little or no down payment on first mortgage, or borrow for other purposes using home as collateral
- **Cash-out refi** – allows consumer to refinance and take equity out of home for other purposes. When interest rates lower, consumer has roughly same monthly payment
- **Jumbo mortgage** – loan amount is larger than the maximum eligible for purchase by Fannie, Freddie or FHLBI (currently $417,000)
- **Nonconforming mortgage** – does not meet the purchase requirements of Fannie, Freddie or FHLBI because it is too large or does not meet underwriting criteria

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Three Mortgage Market Origination Channels

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1. **Mortgage brokers – independent contractors originate loans for multiple lenders who underwrite and close loans.**
2. **Loan correspondents – generally smaller lenders originate, underwrite and close loans and immediately sell them to other (generally larger) lenders.**
3. **Retail lenders – lenders that originate, underwrite, and close loans without reliance on brokers and/or correspondents.**

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Three Mortgage Market Origination Channels

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- **Large mortgage lenders may originate loans through a combination of the three channels:**
  - Brokers
  - Correspondents
  - Retail banks
- **Federally-insured banks (correspondents or retail) and their subsidiaries subject to Federal regulation (HOEPA, Reg. Z and HMDA)**

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2006 Mortgage Originations by Type - Nationally

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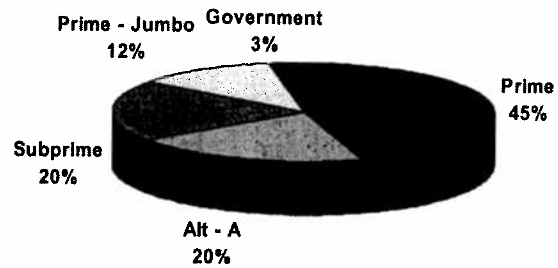

- **From 2003 to 2006, subprime lending rapidly grew from 9% to 24% of market**
- **Of top 25 originators of subprime and Alt-A loans in 2006, 21 were** non-bank **lenders**

Source: Credit Suisse and GAO

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MI Subprime Lending Originations Increased

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	Number of High Cost Loans	% of Total Loans (Number)	Dollar Volume of High Cost Loans	% of Total Loans (Dollars)
2005	**93,231**	**18.4%**	**$8.7 billion**	**13.2%**
2006	**131,303**	**31.8%**	**$13.1 billion**	**26.5%**

WSJ Study – Michigan Lending (October 11, 2007)

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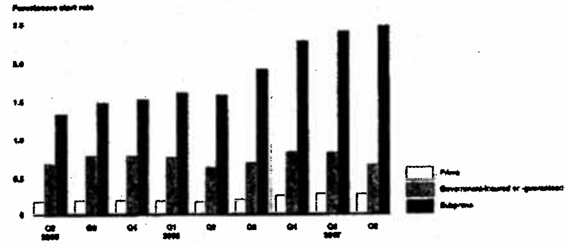
GAO

Default and Foreclosure Trends

National Level (Market Segments)

- Changes in foreclosure start rates have varied by market segment.



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National Foreclosure Trends

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- **GAO noted a recent study predicts 13% of the ARMs (1.1 million loans) originated in 2004 to 2006 will foreclose in next seven years**

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MI Foreclosure Trends

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For second quarter 2007

- **Four states historical max:**
  - Florida
  - Minnesota
  - Maine
  - Nevada

- **Five states max foreclosure inventories:**
  - Maine
  - Minnesota
  - Rhode Island
  - Michigan
  - Ohio

Source: GAO October 10, 2007 draft study.

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MI Foreclosure Growth Modest, But Starts High

Building Partnerships. Serving Communities.

- **From 2005 to 2007 (through second quarter), states in the industrial Midwest (e.g., Michigan, Ohio and Indiana) have seen more modest growth in default and foreclosure rates**
- **Midwest is a significant part of increase in the number of troubled loans, but their default and foreclosure rates started at higher levels**

Source: GAO October 10, 2007 draft study.

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Factors Causing Foreclosures

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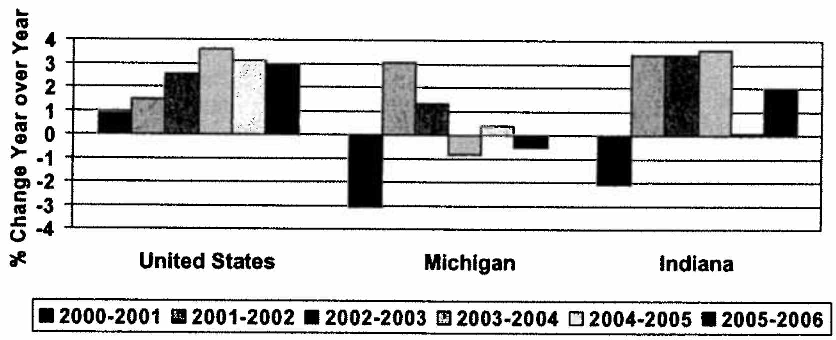
- Rising interest rates
- Economy and jobs (MI rate of employment 4th quarter 2001 to 2nd quarter 2007 was -4.7%, worst in nation)



Source: Bureau of Economic Analysis (BEA)

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Factors Causing Foreclosures

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- **Declining home prices (increased property taxes)**
- **Private label securitizations:**
  - More loan features and lax underwriting which increase default risk (Jan. 2005 – Mar. 2007)
- **Lenders' and servicers' willingness to modify loans:**
  - Tax policy and speed of local judicial process
  - Locating the national servicer
  - Creating workout exceptions for secondary market investors
- **Amount of liquidity and new loan product availability:**
  - Don't chill pending innovation
  - Curtail abusive non-bank lending practices under Michigan's jurisdiction

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Factors Causing Foreclosures

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- **Eased underwriting and certain loan features increase foreclosure risk, even when borrower credit scores are controlled:**
  - Higher loan-to-value (less or no down payment)
  - Prepayment penalties (especially in later years)
  - No or low income documentation
  - Interest-only loans
  - Negative authorization loans (adding deferred interest payments to loan balance)

Source: GAO October 10, 2007 draft study.

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Rating Agency Response to Subprime Losses

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- **Bear Stearns hedge fund subprime investments rapidly declined in value (June 2007)**
- **In mid 2007, rating agencies increased default and loss assumption on private label MBS secondary market securitizations**
- **S&P has in first-second quarter 2007 downgraded 1,713 MBS valued at $23 billion (6% of subprime S&P rated)**
- **S&P identified an increase in fraud in the mortgage market**

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FHLB System Response to Subprime Losses

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- Mortgage companies and hedge funds no longer willing to invest in subprime
- Traditional FHLBank System borrowings and mortgage purchases increased

Aug. '07 - 17% Advances Increase

Sept. '07 - 7% Advances Increase

- In total, the FHLBanks provided $163 billion to help calm the credit markets

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FHLBI Responsible Lending

Building Partnerships. Serving Communities.

- **FHLBI's Anti-Predatory and Subprime Lending Policy – no purchase or collateral value for loans:**
  - Requiring borrower to obtain prepaid, single premium credit life, credit unemployment or other similar credit insurance
  - Requiring mandatory arbitration
  - Charging prepayment penalties for payoff of loan after the early years
  - High cost loan under HOEPA and Reg. Z
- **FHLBI community bank members certify compliance**

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Policy Considerations for MI

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•Consider programs to reduce foreclosures:

- FHA Secure (August 2007) –for current loans where ARM resets high
- MSHDA's "Save the Dream" initiative
- FHLBI studying ways to assist community banks in refinancing responsible borrowers

•License and regulate non-bank mortgage originators:

- Dedicated Attorney General/OFIS staff
- Annual reporting to MI legislator

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Policy Considerations for MI

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•Mortgage fraud laws should be strengthened at non-bank retail level:

- Appraisal conduct, but must be clear
- Make sure MI has adequate investigation and enforcement mechanism

•Avoid ambiguous borrower suitability and assignee liability laws:

- Uncertainty discourages national mortgage investors
- As secondary market capital leaves MI – it is hard to get it back

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Policy Considerations for MI

Building Partnerships. Serving Communities.

- **If high-cost home loan law passed, ceilings and bright lines must be clear. Understand that policy of secondary market is not to buy these loans – be mindful of chilling effect.**
- **State laws should closely follow the new federal regime to be adopted in response to the crisis:**
  - New Federal Reserve regulations
  - Bills being introduced in Congress (consider state safe harbor – non-banks comply with federal standards)
- **Consumer education and homeownership counseling:**
  - High school financial literacy curriculum
  - Indiana created a new counseling fund

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Policy Considerations for MI

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- **Housing speculators and secondary market subprime investors should not be bailed out:**
  - Let the markets adjust
  - Broad loan modification as suggested by FDIC chair seem impractical
  - Market is reacting, underwriting standards are tightening
  - Secondary market investors are not buying high risk, inappropriate mortgage structures
  - Rating agencies are balancing risk-return when rating structures
  - Federal Reserve has lowered interest rates
- **FHLBI's 221 member MI financial institutions stand ready to lend under continued sound lending practices**

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Federal Home Loan Bank of Indianapolis

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